No. 15434

In the United States Court of Appeals for the Ninth Circuit

AH PAH REDWOOD CO., A CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petition for Review of the Decision of the Tax Court of the United States

BRIEF FOR THE RESPONDENT

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INDEX

CITATIONS

Cases:

Cases—Continued

Statute:

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OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 16-28) are reported at 26 T.C. 1197.

JURISDICTION

This petition for review (R. 29-32) involves federal income taxes for the taxable years 1948 and 1949. On June 18, 1953, the Commissioner of Internal Revenue mailed the taxpayer a notice of deficiency which, together with penalties (Section 291 (a) of the Internal Revenue Code of 1939), totalled

$47,880.27 (R. 5-7). Within ninety days thereafter, and on September 16, 1953, the taxpayer filed a petition with the Tax Court for a redetermination of the deficiency under the provisions of Section 272(a) of the 1939 Code. (R. 3-5.) The decision of the Tax Court, in favor of the Commissioner, was entered October 28, 1956. (R. 28.) On October 29, 1956, taxpayer filed with the Tax Court a motion for revision of the decision of October 28, 1956.[1] (R. 76-82.) The case is brought to this Court by a petition for review filed December 18, 1956. (R. 29-31.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

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[1] Taxpayer filed a petition for review by this Court without action having been taken by the Tax Court on the motion for revision. It appears that the Tax Court took no action on the motion for revision after the petition for review was perfected. The filing of a notice of appeal or petition for review from a final judgment or decision terminates all further jurisdiction of the lower court and transfers jurisdiction to the appellate tribunal. *Keyser* v. *Farr*, 105 U.S. 265; *Thompson* v. *Harry C. Erb., Inc.*, 240 F. 2d 452 (C.A. 3d); *Jordan* v. *Federal Farm Mortgage Corp.*, 152 F. 2d 642 (C.A. 8th); *Walleck* v. *Hudspeth*, 128 F. 2d 343 (C.A. 10th); *Miller* v. *United States*, 114 F. 2d 267 (C.A. 7th). There is authority that this holds true even where the motion with the lower court was filed and pending at the time the notice of appeal was filed. *Secretary of Banking of Pennsylvania* v. *Alker*, 183 F. 2d 429 (C.A. 3d); *Switzer* v. *Marzall*, 94 F. Supp. 721 (D.C. D.C.); *J. J. Theatres, Inc.* v. *Twentieth Century-Fox Film Corp.*, 112 F. Supp. 674 (S.D. N.Y.). The theory would be that where a moving party invokes the jurisdiction of an appellate court by filing a notice of appeal, he will be deemed to have abandoned, and in effect withdrawn, any motions he has pending in the lower court.

QUESTIONS PRESENTED

1. Whether amounts received by taxpayer during 1948 and 1949 from Coast Redwood Company resulted from a disposal of timber held for less than six months prior to such disposal under Section 117 (k) (2) of the Internal Revenue Code of 1939, as held by the Tax Court, or whether, as taxpayer contends, the timber had been held for more than six months prior to disposal.

2. Whether the Tax Court erred in holding that taxpayer's depletion allowance could not be adjusted retroactively for 1948 and 1949 under Section 23 (m) of the 1939 Code so as to reflect a revision, made in 1954, of the original estimate of board feet of timber.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the statute and Regulations involved are set forth in the Appendix, *infra*.

STATEMENT

The facts of this case are undisputed and are taken from the Tax Court's findings (R. 16-19), the transcript of testimony (R. 37-57), and exhibits introduced into evidence (R. 57-76).

The taxpayer, Ah Pah Redwood Co., is a corporation organized under the laws of California, with its main office at Portland, Oregon. It filed its returns for the tax years 1948 and 1949 on a calendar year basis. (R. 16-17.)

By contract dated December 13, 1946 (hereinafter called the Sage Agreement), Union Bond & Trust Company agreed to purchase from the Sage Land &

Lumber Company, Inc., all the land and timber on certain tracts described therein (hereinafter called the Sage Tract) in Humboldt County, California. (R. 17-18; Ex. 1-A, R. 57-71.) Mr. A. K. Wilson was the president of Union Bond & Trust Company, as well as president of International Pacific Pulp and Paper Company (R. 51-52) which acquired rights in the Sage Agreement and which sold 16,022,060 board feet of the timber covered therein to Coast Redwood Company, Inc. (hereinafter referred to as Coast Redwood), during 1946 and 1947 (R. 19, 47).

Upon its organization in October, 1947, taxpayer purchased all the right, title, and interest of "the buyer" in the Sage Agreement and all of the timber and land covered thereby for $1,443,838.99. (R. 17-18.) Shortly after this purchase, taxpayer, in October, 1947, under an oral or implied contract with Coast Redwood, allowed the latter to begin cutting timber from the Sage Tract and pay therefor $5.00 per thousand feet as removed. On January 9, 1950, taxpayer entered into a formal written agreement with Coast Redwood pursuant to which the former agreed to sell to the latter all of the timber and land covered by the Sage Agreement. (R. 18.)

During 1950, taxpayer sold 33,883,000 board feet of timber covered by the Sage Agreement to the A. K. Wilson Lumber Company. (R. 19.) Mr. A. K. Wilson was also president of the taxpayer corporation as well as president of Coast Redwood and A. K. Wilson Lumber Company. (R. 51-52.)

In the years 1948 and 1949, taxpayer reported its income from the receipts from Coast Redwood as

long term capital gains. It used a basis for depletion of $3.941566 per thousand board feet. This basis, which was agreed to by the Commissioner, was arrived at by dividing the amount of timber on the Sage Tract, as was shown on Schedule A of the Sage Agreement per the French cruise, which amount taxpayer assumed to be the correct quantity thereof, into the total purchase price paid by taxpayer for such agreement. In 1952, taxpayer first became aware of the fact that Schedule A of the Sage Agreement erroneously overstated the quantity of timber on the Sage Tract by a substantial amount. The Tax Court found that, upon an actual cruise made shortly after logging operations ceased in November of 1954, it was ascertained that such overstatement was approximately double the actual amount and that there was a "fall-down" of approximately 48 per cent. (R. 18-19.) According to the French cruise approximately 70 million board feet should have remained on the Sage Tract as of November, 1954, whereas the new cruise showed that approximately 35 to 37 million board feet remained standing on the tract. (R. 41, 43-44.)

The Tax Court held that taxpayer was not entitled to capital gains treatment for 1948 and 1949, and that the 1954 revision of the depletion rate could not be applied retroactively to those years. (R. 19-27.)

SUMMARY OF ARGUMENT

I

The Tax Court was correct in holding that taxpayer's oral agreement with Coast Redwood constituted a disposal of the Sage timber, and that inas-

much as taxpayer had not held the timber for a period of more than six months at the time of such disposal, capital gains treatment was not available under Section 117(k)(2).

Taxpayer's contention that, if the agreement created only a license to cut and remove timber, there was no disposal of any particular timber until it was cut and removed, is obviously incorrect. The statute states that disposal of the timber must be "under" a "contract", thus clearly contemplating that the date of disposal is the date of the contract. All of the timber cut and removed during 1948 and 1949 was disposed of by the oral contract.

Taxpayer's theory is in direct conflict with Treasury Regulations 111, Section 29.117-8, which state that, to qualify for capital gains treatment, a taxpayer must have owned the timber "for a period of more than six months *prior to the date* of such contract." (Italics supplied.) The Tax Court, in *Springfield Plywood Corp.* v. *Commissioner*, 15 T.C. 697, 703, approved this regulation as "reasonable and valid", and proceeded to hold that a "cutting license" disposed of the timber on the date the parties entered into the agreement, and since the taxpayer had not held the timber for more than six months prior to such agreement, capital gains treatment was unavailable. Congress was made expressly aware of the *Springfield Plywood* decision and of the Bureau's interpretation of the statute, but a bill which would have changed the law so that the date of disposal would be deemed to be the date the timber was cut, was rejected by both houses. Since ulti-

mately no revision of Section 117(k)(2) was made, Congress must be considered as having approved the Bureau's interpretation.

Inasmuch as the oral contract was entered into the same month that taxpayer acquired the timber, taxpayer had not held the timber for a period of more than six months prior to disposal and cannot, therefore, qualify for capital gains treatment.

II

Assuming that the Tax Court was correct in denying capital gains treatment, taxpayer is entitled to deductions for depletion. But taxpayer, having discovered in 1954 that the original estimate of standing timber was overstated, may not apply the revised estimate retroactively to adjust upward the depletion deductions for 1948 and 1949. Section 23(m) of the 1939 Code very clearly directs that a revision of the unit rate of depletion, based upon a new estimate of the recoverable units, shall only be applied "for subsequent taxable years". Three other Circuits have construed this language as meaning that the revised estimate may only be applied prospectively. Similarly, Section 29.23(m)-26 of Regulations 111, conforms exactly to the language of the statute, forbidding a retroactive adjustment.

Section 29.23(m)-22 of Regulations 111, which taxpayer claims authorizes a retroactive application, has no reference to the problem at hand. That section relates to the matter of *revalution* of the basis of the timber property, as opposed to a redetermination of the quantity of timber with which Section

23(m) and Section 29.23(m)-26 of Regulations 111 are concerned. Similarly the case on which taxpayer relies is not pertinent, as the court was dealing with revaluation and not revision of units.

It may be that there was gross error in the original estimate. But such a conclusion does not dispose of this case. For that matter, taxpayer need not prove gross error at all to have a revision under the appropriate section of the Regulations. But once having established that a revision is in order, Section 23(m) of the Code makes very clear that the revision must be applied so as to recapture the remaining costs in "subsequent taxable years".

ARGUMENT

I

Taxpayer Did Not Hold the Timber For a Period of More Than Six Months Prior To Disposal and Is Thus Not Entitled To Capital Gains Treatment

The Tax Court decided the capital gains issue for the Commissioner on two grounds. The Tax Court held first that capital gains treatment is not available under Section 117(j) and (k)(2) of the 1939 Code (Appendix, *infra*) where the timber disposed of was held for sale to customers in the ordinary course of business. See *Boeing* v. *United States*, 98 F. Supp. 581 (C. Cls.).[2] The Tax Court also held

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[2] In the *Boeing* case, the Court of Claims concluded, after tracing the legislative history of Section 117(k)(2), that the taxpayer was entitled to capital gains treatment on the Greenwood contract (pp. 584-585)—

> unless perhaps it can be said that plaintiff was in the

that taxpayer's oral agreement with Coast Redwood constituted a disposal of the Sage timber, and inasmuch as taxpayer had not held the timber for a period of more than six months at the time of such disposal, capital gains treatment was not available under Section 117(k)(2).

The Commissioner did not urge the "for sale to customers in the ordinary course of business" argument, adopted by the Tax Court, and has since stated that this ground for the decision does not represent the position of the Internal Revenue Service.[3] Accordingly, on the capital gains issue we direct at-

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trade or business of selling timber to logging companies.

The court held that the taxpayer was not in the business of selling timber, but was merely liquidating an investment, and, therefore, having otherwise qualified under Section 117(k)(2), was entitled to capital gains. See also *Willey* v. *Commissioner,* decided December 7, 1950 (1950 P-H T.C. Memorandum Decisions, par. 50,299), affirmed, 199 F. 2d 375 (C.A. 6th); *Commissioner* v. *Boeing,* 106 F. 2d 305 (C.A. 9th), certiorari denied, 308 U.S. 619.

[3] Rev. Rul. 57-90, 1957-10 Int. Rev. Bull. 9, states as follows:

> In the case of the disposal of timber, held for more than six months prior to such disposal, by the owner thereof under any form or type of contract by virtue of which the owner retains an economic interest in such timber, pursuant to the provisions of Section 631(b) of the Internal Revenue Code of 1954, the gain or loss on such disposal is subject to the tax treatment provided by Section 1231 regardless of the nature of the taxpayer's business or the purpose for which the timber is held. To the extent that the opinion in *Ah Pah Redwood Co.* v. *Commissioner,* 26 T.C. 1197, may be inconsistent with the foregoing, it does not represent the position of the Internal Revenue Service.

tention only to the question whether the taxpayer held the timber for a period of more than six months before disposal.

Taxpayer argues that the oral agreement was only a license to cut timber (Br. 25), and that since such a license is revocable, there could be no disposal until the timber was cut and removed (Br. 29-30). We do not concede that the agreement was a cutting license. The burden was on taxpayer to prove that it qualified under Section 117(k), and having offered insufficient evidence of the legal rights and duties created by the agreement,[4] taxpayer assumes too much in positively characterizing it a cutting license. Having failed to establish that the agreement was a license, the whole substance of taxpayer's argument, based as it is on revocability, disappears.[5]

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[4] In this connection the Tax Court observed (R. 23): "While there is no direct evidence of the precise terms of the oral cutting contract entered into between petitioner and Coast, such contract, for aught that is shown, looked immediately to the severance and removal of all timber standing upon the Sage Tract."

[5] For all the evidence shows, the oral agreement created a lease or some other non-revocable interest in the realty. This, however, would not imply that the taxpayer could raise the bar of the statute of frauds. This is a federal tax case, and the Code takes precedence over local law where the language clearly so indicates. *Watson* v. *Commissioner*, 345 U.S. 544, 551, rehearing denied, 345 U.S. 1003; *Burnet* v. *Harmel*, 287 U.S. 103, 110. Section 117(k)(2) speaks of a disposal of timber "under any form or type of contract." Clearly this broad language is sufficient to encompass an oral contract.

In addition, the statute of frauds, being designed to prevent a fraud by one party against another to the contract, has never been available to or against a total stranger to

But even assuming *arguendo* that the agreement created a license, and that disposal by way of license after a holding period of more than six months would qualify taxpayer for the benefits of Section 117(k)(2), the fact is that taxpayer had not held the timber for a period of more than six months prior to its disposal within the meaning of the section.

The Commissioner's position is that the statute contemplates that the taxpayer must have owned the timber for a period of more than six months *prior to the date of the contract by which it was disposed.* Inasmuch as the oral contract was entered into the same month that taxpayer acquired the timber (R. 18), the disposal took place prior to six months from acquisition, and taxpayer cannot, therefore, qualify under Section 117(k)(2).

Taxpayer contends that there was no disposal until the timber was cut and removed, and that for all timber removed after six months from date of acquisition, capital gains treatment is available. But the statute states that disposal of the timber must

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the contract, such as the Commissioner, especially where the contract has been fully executed to the satisfaction of the parties thereto. *Charlotte Union Bus Station* v. *Commissioner,* 209 F. 2d 586, 589 (C.A. 4th); *Joseph S. Finch & Co* v. *Commissioner,* 23 B.T.A. 1153; *Camp* v. *Commissioner,* 21 B.T.A. 962. See also *Marbelite Corp.* v. *Commissioner,* 77 F. 2d 713 (C.A. 9th). This principle has particular reference where, as here, under local law, the oral contract is not void, but merely voidable (*O'Brien* v. *O'Brien,* 197 Cal. 577, 241 Pac. 861), and where once having been fully performed by both parties, the statute of frauds is no longer available as a defense even by one party to the contract against the other (*Bates* v. *Babcock,* 95 Cal. 479, 30 Pac. 605; *Robison* v. *Hanley,* 136 C.A. 2d 820, 289 P. 2d 560).

be "under" a "contract", thus clearly contemplating that the date of disposal is the date of the contract. The only contract under which the timber could have been disposed of was the oral contract of October, 1947. All removals of timber up to the date of the written contract of January 9, 1950, relate back to and were disposed of under the oral contract. Accordingly, it is of no moment that this contract may have created a revocable license. Had taxpayer revoked the license, the timber removed up to the time of revocation would have nonetheless been disposed of under the oral contract. Not having revoked the license, all of the timber cut and removed during 1948 and 1949 was disposed of under the oral contract.[6]

Taxpayer's theory is in direct conflict with Treasury Regulations 111, Section 29.117-8 (Appendix, *infra*), which state that—

> If a taxpayer disposes of timber under any form or type of contract whereby he retains an economic interest in such timber, *the disposal under the contract* shall be considered to be a sale of such timber. * * * *If the taxpayer owned the*

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[6] Taxpayer notes (Br. 25) that 33,883,000 board feet were sold to A. K. Wilson Lumber Company in 1950 (R. 19). But this in no way militates against our position that the timber removed by Coast Redwood during the taxable years was disposed of by the oral agreement. Furthermore, the sales to A. K. Wilson Lumber Company came after the tax years here in dispute and after the new contract of January 9, 1950. It should also be kept in mind, in this regard, that Mr. A. K. Wilson was president not only of taxpayer corporation, but of Coast Redwood and A. K. Wilson Lumber Company as well. (R. 51-52.)

> *timber for a period of more than six months prior to the date of such contract*, for the purposes of section 117(j) such timber shall be considered to be property used in the trade or business for the taxable year for which it is considered to have been sold, * * *. (Italics supplied.)

It is seen that the Regulations construe the statute as meaning that the disposal takes place at the date of the contract, and that a taxpayer claiming the benefit of the section must have owned the timber for more than six months "prior to the date of such contract." This construction, being in complete harmony with the language of the statute, is most certainly reasonable, and should be approved. *Commissioner* v. *Wheeler*, 324 U.S. 542, 546, rehearing denied, 325 U.S. 892; *Universal Battery Co.* v. *United States*, 281 U.S. 580, 584; *Brewster* v. *Gage*, 280 U.S. 327, 336. Indeed, the Tax Court, in *Springfield Plywood Corp.* v. *Commissioner*, 15 T.C. 697, 703, said that this regulation is "reasonable and valid", and Congress, as we will show below, after giving express consideration to the *Springfield Plywood Corp.* decision, approved the Tax Court's construction that timber removed under a cutting license is disposed of at the date of the contract.

In the *Springfield Plywood* case, *supra*, the taxpayer acquired certain timber in January, 1943. On May 14, 1943, before the expiration of six months, the taxpayer entered into an agreement with the D. & W. Lumber Company, which agreement was described therein as "the cutting licence." The Lum-

ber Company's rights were described therein as the "right and license to enter upon the land and cut and log the timber." Elsewhere the agreement provided that upon default in payment, "the right and license hereby granted to enter upon said lands and cut said timber" were to be suspended until the default was cured. The question as framed by the court was (15 T.C., p. 701):

> Did the contract dispose of the timber, or was it disposed of only when cut and removed?

In a well-considered opinion, reviewed by the court, the Tax Court upheld Section 29.117-8 of Regulations 111, and held that the "cutting license" disposed of the timber on the date the parties entered into the agreement, and, therefore, capital gains treatment was unavailable.

It is true that the Tax Court thought there had been a sale on May 14, 1943, when the contract with the lumber company was agreed upon,[7] but contrary to the inference taxpayer draws (Br. 25), that was not the sole ground for the decision. The argument had been advanced that the contract was only a license to cut, and that, therefore, there was no disposal until the timber was cut and removed. In answer, and as a distinct ground for the decision, the Tax Court said that even if the May 14, 1943, agreement was not a sale (thus tacitly assuming a license), "in our opinion within the statute and with-

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[7] The agreement also referred to the lumber company as "vendee" and the taxpayer as "vendor."

ing a reasonable and valid regulation, disposal took place on that date." 15 T.C., p. 703.

The *Springfield Plywood* case came to the attention of Congress at its next session, and the Senate Finance Committee recommended that Section 117 (k)(2) be amended to change the law of the case (S. Rep. No. 781, Part 2, 82d Cong., 1st Sess., p. 44 (1951-2 Cum. Bull. 545, 575)):

> Your committee has added a provision to section 117(k)(2) to the effect that the date of the disposal of the coal or timber shall be deemed to be the date such coal is mined or such timber is cut, rather than the date of the royalty contract as it was held in *Springfield Plywood Corporation* (15 T.C. No. 91 (1950)).

However, after consideration by the Conference Committee, the proposed amendment was discarded, as is evidenced by the following discussion on the Senate floor (Senate Discussion on Report of Conference Committee, 97 Cong. Record, Part 10, p. 13435):

> Mr. GEORGE. * * * the present method for computing the holding period in the case of timber subject to the provision of section 117(k)(2) is retained. Under the present law the holding period runs only to the date of the contract for disposal of the timber, instead of the date of the cutting of the timber as under the bill. * * *
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> * * * *
>
> Mr. MAGNUSON. That means, in effect, that there is no change at all.
>
> Mr. GEORGE. There is no change at all from the present law so far as timber is concerned.

Similarly, in the House (See House Discussion on Report of Conference Committee, 97 Cong. Record, Part 10, p. 13628):

> Mr. DOUGHTON. * * * (a) Holding period for timber: the present method for computing the holding period in the case of timber subject to the provisions of section 117(k)(2) would be retained. Under the present law the holding period runs only to the date of the contract for disposal of the timber, instead of the date of the cutting of the timber as under the bill.

Here is indisputable proof that the Tax Court, in holding that the date of disposal of timber cut under a cutting license is the date the contract is entered into, properly construed Section 117(k)(2) in accordance with the intent of Congress. Furthermore, in the course of considering revising Section 117(k)(2), Congress was expressly aware of the interpretation placed on the section by the Internal Revenue Bureau, as expressed in Regulations 111, Section 29.117-8. Since ultimately no revision of the section was made, Congress must be considered as having approved the Bureau's interpretation. *Helvering* v. *Winmill*, 305 U.S. 79, 82; *Helvering* v. *Reynolds Co.*, 306 U.S. 110, 115; *United States* v. *Armature Exchange*, 116 F. 2d 969, 971 (C.A. 9th), certiorari denied, 313 U.S. 573.

Inasmuch as taxpayer had not held the timber for a period of more than six months prior to disposal within the meaning of Section 117(k)(2), it does not qualify for capital gains treatment, but must report the amounts in question as ordinary income under Section 22(a) of the 1939 Code. (Appendix, *infra.*)

II

The Revised Estimate of Board Feet of Timber, Made In 1954, Cannot Be Applied Retroactively To Adjust Taxpayer's Depletion Allowance For 1948 and 1949

It should be noted at the outset that if it be decided that taxpayer is entitled to capital gains treatment, there is no issue concerning computation of depletion, as none would be allowable. Regulation 111, Section 29.23(m)-1 (Appendix, *infra*). In determining the capital gain, taxpayer would be allowed full recovery of the cost of the timber. Section 113 (a) and (b) of the Internal Revenue Code of 1939 (Appendix, *infra*); Regulations 111, Section 29.117-8. The Code does not permit a taxpayer who has been accorded capital gains treatment to again deduct as depletion expense the same costs which have already been recovered tax free. *Helvering* v. *Elbe Oil Land Co.*, 303 U.S. 372, 375-376; *Anderson* v. *Helvering*, 310 U.S. 404, 408-409.

Assuming, however, that the Tax Court was correct in holding that taxpayer disposed of the timber before having held it for a period of more than six months, and is not, therefore, entitled to capital gains treatment, taxpayer *is* entitled to deductions for depletion. Section 23(m) of the 1939 Code (Appendix, *infra*); Regulations 111, Section 29.23(m)-1. The problem here is whether taxpayer, having discovered in 1954 that the original estimate of standing timber was overstated, may apply the revised estimate retroactively to adjust upward the depletion deductions for the tax years involved.

The relief which taxpayer seeks is clearly prohibited by the Code, and contrary to taxpayer's assertions, the Regulations are in complete harmony with the Code. The regulation and case which taxpayer relies upon are directed to an entirely different problem from the problem facing the Court, as we shall explain in due course.

The pertinent portion of Code Section 23(m) reads as follows:

> In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection *for subsequent taxable years* shall be based upon such revised estimate. * * * (Italics supplied.)

There is no possible way that the phrase "for subsequent taxable years" can be construed under the facts of this case so as to allow the revised estimate to be applied to taxable years prior to the revision. The legislative history conforms entirely to the language of the statute and shows conclusively that the revised estimate is to be applied prospectively only. See S. Rep. No. 665, 72d Cong., 1st Sess., p. 16 (1939-1 Cum. Bull. (Part 2) 496, 507-508.) Similarly the Regulations conform exactly to the language of the statute (Regulations 111, Section 29.23(m)-26 (Appendix, *infra*)), stating that where it is subsequently ascertained that there are more or less units of timber remaining than the original estimate indicates,

> then the original estimate (but not the basis for depletion) shall be revised and the annual depletion allowance with respect to the property *for subsequent taxable years* shall be based upon the revised estimate. (Italics supplied.)

The Fifth Circuit had the occasion to construe Section 23(m) in *Petit Anse Co.* v. *Commissioner*, 155 F. 2d 797, and its decision is direct authority for our position. It was held that the Commissioner could not apply a depletion rate, based upon a revised estimate, retroactively to tax years prior to the date of revision.[8] The court emphasized (p. 799) that the statute provides that the allowance under the revised estimate would be "for subsequent taxable years" only. The court concluded that (pp. 798-799)—

> We interpret this statute [Section 23(m)] to mean that the revision for depletion *when discovered* as a result of operations or development work will be only as to the allowance for depletion in subsequent taxable years, and that there would be no retroactive revision of the depletion

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[8] We would point out that in the *Petit Anse* case the Commissioner did not urge as a general rule that a revision might be applied retroactively. The Commissioner's position was that the taxpayer had discovered, prior to the tax years involved, the facts requiring a revision, and that the revision should occur as of the time of the discovery rather than some subsequent date when the taxpayer elected to make known the facts. The court held against the Commissioner because in its view there was no evidence to support a factual finding that the taxpayer had discovered the excesses before the tax years. Compare *Beck* v. *Commissioner*, 15 T.C. 642, affirmed, 194 F. 2d 537 (C.A. 2d), discussed *infra*.

> allowance for the years before the discovery of the existence of recoverable units in excess of the prior estimate.

Similarly in *McCahill* v. *Helvering*, 75 F. 2d 725, the Eighth Circuit rejected a taxpayer's attempt to apply a revised rate retroactively to 1929 and 1930. The court had this to say (p. 728):

> where revision is made on account of "information subsequently obtained," the government cannot go back into the prior years and recover the excessive deductions, and neither can the taxpayer go back to the years 1929 and 1930, before the error was known, and, by obtaining deductions for those years, upset the basis for depletion as it stood in those years.

Accord: *Kehota Mining Co.* v. *Lewellyn*, 28 F. 2d 995 (W. D. Penn.), affirmed, 30 F. 2d 817 (C.A. 3d).

As the Tax Court pointed out (R. 26-27), the case of *Beck* v. *Commissioner*, 15 T.C. 642, affirmed, 194 F. 2d 537 (C.A. 2d), does not conflict with the general scheme of Section 23(m). There the taxpayer was aware of facts which would have required a downward revision of the depletion deduction for the years 1938 through 1941, but did not come forward with the facts. Subsequent to the tax years the Commissioner discovered the facts and proceeded to revise the depletion allowance for the years involved. In an opinion upheld by the Second Circuit, the Tax Court approved the Commissioner's action, saying (p. 660):

> The statute contemplates no controversy as to when the ascertainment was made. It implies that the taxpayer himself, under our system of

> self-levy, makes the correct adjustment when he himself ascertains the need for correction in depletion rate. The statute does not imply that the party to whom it would be an immediate tax-wise advantage to suppress the information of a need for adjustment, has any privilege not to come forward and make the necessary correction in the return. * * *
>
> By no possible interpretation of the statute can it be said that it is the duty of the Government to ferret out the fact that a correction in depletion is in order. * * *

The meaning of the *Beck* decision is that the revision will be deemed to have been made as of the date that the taxpayer ascertains facts requiring a downward revision. Under our system of self-assessment, a taxpayer cannot claim an unfair advantage arising from his own silence where he had a clear duty to speak. See footnote 8, *supra*.

It is of no moment whether the taxpayer in the instant case became aware of the error in the original estimate before or after the tax years. Even if taxpayer knew of the overrun prior to the tax years, but remained silent in order to see what tax course future events might suggest, it could not now be claimed that the information was known all the time thus requiring a retroactive revision. Under such facts, the election to set the date of revision back to the date of discovery should obviously be with the Commissioner. See *Maletis* v. *United States*, 200 F. 2d 97, 98 (C.A. 9th).

But in any event, the record is quite clear, as the Tax Court observed (R. 27), that before 1952,

neither the taxpayer nor the Commissioner suspected that the prior estimate was wrong. That being the case, the general principle enunciated in Section 23(m) is fully applicable, and taxpayer cannot be allowed a retroactive depletion adjustment. *Petit Anse Co.* v. *Commissioner*, *supra; McCahill* v. *Helvering*, *supra.*

Taxpayer has made no attempt to reconcile its position with the critical language of Code Section 23(m), and indeed, as we have shown and the cases hold, such position is irreconcilable with the Code and with Section 29.23(m)-26 of Regulations 111.

Instead, taxpayer's position is based on a different section of the Regulations which it is claimed authorizes a retroactive application. But we submit that taxpayer's reliance on Section 29.23(m)-22 of Regulations 111 (Appendix, *infra*) is entirely misplaced. That section has no reference to the problem with which we are dealing.

Section 29.23(m)-22 refers to the matter of *revaluation* of the basis of timber property, as opposed to a redetermination of the *quantity* of timber with which Code Section 23(m) and Section 29.23(m)-26 of Regulations 111 are concerned. Ordinarily the basis, for gains purposes, as well as for depletion purposes, is the adjusted cost of the property. See Sections 23(n), 113(a) and (b), 114(b) of the 1939 Code (Appendix, *infra*). However, there are instances where market value is to be used as the basis. Thus in the case of property acquired before March 1, 1913, if the cost basis is less than the fair market value as of March 1, 1913, the latter is

to be used as the basis. Section 113(a)(14), 1939 Code (Appendix, *infra*). See also Section 114(b)(2) of the 1939 Code relating to discovery value in the case of mines.

Unlike cost basis where a taxpayer knows at the outset how much he paid, value basis is often uncertain, and revaluation may subsequently be in order. In recognition of the uncertainties attendant upon the use of value basis, Section 29.23(m)-22 allows a revaluation of timber property under certain prescribed conditions, namely, "in the case of misrepresentation or fraud or gross error as to any facts known on the date as of which the valuation was made." But revaluation of timber property is an entirely different matter from that of revising the number of depletive units. A revaluation changes the total depletion to be allowed over the life existence of the wasting asset. A revision of the number of units, on the other hand, leaves the total depletion allowance intact and merely reallocates the deduction per unit. Nothing contained in Section 29.23(m)-22 can be taken as having any application to the matter or revision of units, which revision Code Section 23 (m) expressly directs must only be applied prospectively. For that matter, Section 29.23(m)-22 refers the taxpayer specifically to Section 29.23(m)-26 for the procedure and rules applicable to a revision of the remaining depletive units. The last sentence of Section 29.23(m)-22 reads:

> The depletion unit should be changed when a revision of the remaining number of units of recoverable timber in the property has been made

> *in accordance with section 29.23(m)-26.* [Italics supplied.]

It may be that there was gross error in the original estimate. But such a conclusion does not dispose of this case. For that matter, taxpayer need not prove gross error at all to have a revision. Section 29.23 (m)-26 allows revision for a number of reasons, all less difficult to prove than the misrepresentation, fraud, or gross error under Section 29.23(m)-22. Thus the original estimate may be revised for subsequent taxable years under any of the following conditions:

> * * * the result of the growth of the timber, of changes in standards of utilization, of losses not otherwise accounted for, of abandonment of timber, or of operations or development work * * *.

The Seventh Circuit case on which taxpayer relies (*Rust-Owen Lumber Co.* v. *Commissioner*, 74 F. 2d 18), is not pertinent because, as is even made clear from the excerpts therefrom quoted by taxpayer (Br. 33-35), the court was dealing with revaluation and not revision of units. Of course in that case the value of the timber was inextricably tied to the number of units inasmuch as the total aggregate value was the product of the estimated value per unit multiplied by the number of units. But this cannot be allowed to divert attention from the basic problem in the case, that of revaluing the timber. It is in this connection that the court was compelled to inquire whether there was gross error sufficient to entitle the taxpayer to a revaluation under Article 230 of Regulations 69,

promulgated under the Revenue Act of 1926, predecessor of Section 29.23(m)-22.[9]

Section 23(m) clearly requires that any revision which may be made in taxpayer's depletion rate must be applied so as to recapture the remaining cost in "subsequent taxable years." The cases hold that this language means what it says, and the Regulations also adhere to the literal wording of the Code. The Tax Court was correct in rejecting taxpayer's application to apply a revised rate retroactively.

CONCLUSION

For the reasons advanced above, the decision of the Tax Court is correct on both issues and should be affirmed.

Respectfully submitted,

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JUNE, 1957.

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[9] We might further point out that taxpayer is unjustified in stating (Br. 33) that the taxpayer in the *Rust-Owen Lumber Co.* case was allowed to revalue its timber "as of the original date of valuation." There was no issue of retroactive application presented to the court in that case.

APPENDIX

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In

the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

For percentage depletion allowable under this subsection, see section 114(b), (3) and (4).

(n) *Basis for Depreciation and Depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

* * * *

(26 U.S.C. 1952 ed., Sec. 23.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * *

(14) *Property acquired before March 1, 1913.*—In the case of property acquired before March 1, 1913, if the basis otherwise determined under this subsection, adjusted (for the period prior to March 1, 1913) as provided in subsection (b), is less than the fair market value of the property as of March 1, 1913, then the basis for determining gain shall be such fair market value. In determining the fair market value of stock in a corporation as of March 1, 1913, due regard

shall be given to the fair market value of the assets of the corporation as of that date.

* * * *

(b) [as amended by Sec. 1, Act of July 14, 1952, c. 741, 66 Stat. 629] *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

* * * *

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount—

(i) allowed as deductions in computing net income under this chapter or prior income tax laws, and

* * * *

(26 U.S.C. 1952 ed., Sec. 113.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * *

(b) *Basis for Depletion.*—

(1) *General rule.*—The basis upon which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property, except as provided in paragraphs (2), (3), and (4) of this subsection.

* * * *

(26 U.S.C. 1952 ed., Sec. 114.)

SEC. 117. CAPITAL GAINS AND LOSSES.

* * * *

(j) [as added by Sec. 151(b) of the Revenue Act of 1942, c. 619, 56 Stat. 798, and amended by Sec. 127(b) of the Revenue Act of 1943, c. 63, 58 Stat. 21] *Gains and Losses from Involuntary Conversion and from the Sale or Exchange of Certain Property Used in the Trade or Business.*—

(1) *Definition of property used in the trade or business.*—For the purposes of this subsection, the term "property used in the trade or business" means the property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Such term also includes timber with respect to which subsection (k)(1) or (2) is applicable.

* * * *

(k) [as added by Sec. 127(a) of the Revenue Act of 1943, *supra*] *Gain or Loss Upon the Cutting of Timber.*—

(1) If the taxpayer so elects upon his return for a taxable year, the cutting of timber (for sale or for use in the taxpayer's trade or business) during such year by the taxpayer who owns, or has a contract right to cut, such timber providing he has owned such timber or has held such contract right for a period of more than six months prior to the beginning of such year) shall be considered as a sale or exchange of such timber cut during such year. In case such election has been made, gain or loss to the taxpayer shall be recognized in an amount equal to the difference between the adjusted basis for depletion of such timber in the hands of the taxpayer

and the fair market value of such timber. Such fair market value shall be the fair market value as of the first day of the taxable year in which such timber is cut, and shall thereafter be considered as the cost of such cut timber to the taxpayer for all purposes for which such cost is a necessary factor. If a taxpayer makes an election under this paragraph such election shall apply with respect to all timber which is owned by the taxpayer or which the taxpayer has a contract right to cut and shall be binding upon the taxpayer for the taxable year for which the election is made and for all subsequent years, unless the Commissioner, on showing of undue hardship, permits the taxpayer to revoke his election; such revocation, however, shall preclude any further elections under this paragraph except with the consent of the Commissioner.

(2) In the case of the disposal of timber (held for more than six months prior to such disposal) by the owner thereof under any form or type of contract by virtue of which the owner retains an economic interest in such timber, the difference between the amount received for such timber and the adjusted depletion basis thereof shall be considered as though it were a gain or loss, as the case may be, upon the sale of such timber. * * *

(26 U.S.C. 1952 ed., Sec. 117.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.23(m)-1. [As amended by T.D. 5413, 1944 Cum. Bull. 124] *Depletion of Mines, Oil and Gas Wells, Other Natural Deposits, and Timber; Depreciation of Improvements.*—Section 23(m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. However, no depletion deduction shall be allowed with respect to any timber which the owner has disposed of under any form of contract by virtue of which the owner retains an economic interest in such timber, if such disposal is considered a sale of the timber under section 117(k)(2) of the Code. * * *

Sec. 29.23(m)-22. *Revaluation of Timber Not Allowed.*—No revaluation of a timber property whose value as of any specific date has been determined and approved will be made or allowed during the continuance of the ownership under which the value was so determined and approved, except in the case of misrepresentation or fraud or gross error as to any facts known on the date as of which the valuation was made. Revaluation on account of misrepresentation or fraud or such gross error will be made only with the written approval of the Commissioner. The depletion unit should be changed when a revision of the remaining number of units or recoverable timber in the property has been made in accordance with section 29.23(m)-26.

Sec. 29.23(m)-26. *Determination of Quantity of Timber.*—Each taxpayer claiming or expecting to claim a deduction for depletion is required to estimate with respect to each separate timber account the total units (feet board measure, log scale, cords, or other units) of timber reasonably known, or on good evidence believed, to have existed on the ground on March 1, 1913, or on the date of acquisition of the property, as the case may be. This estimate shall state as nearly as possible the number of units which would have been found present by a careful estimate made on the specified date with the object of deter-

mining 100 per cent of the quantity of timber which the area would have produced on that date if all of the merchantable timber had been cut and utilized in accordance with the standards of utilization prevailing in that region at that time. If subsequently during the ownership of the taxpayer making the return, as the result of the growth of the timber, of changes in standards of utilization, of losses not otherwise accounted for, of abandonment of timber, or of operations or development work, it is ascertained either by the taxpayer or the Commissioner that there remain on the ground, available for utilization, more or less units of timber than remain in the timber account or accounts on the basis of the original estimate, then the original estimate (but not the basis for depletion) shall be revised and the annual depletion allowance with respect to the property for subsequent taxable years shall be based upon the revised estimate.

Sec. 29.117-8 [As added by T.D. 5394, 1944 Cum. Bull. 274]. *Gain or Loss Upon the Cutting and Disposal of Timber.*—

* * * *

(b) *Gain or Loss upon the Disposal of Timber under Cutting Contract.*—If a taxpayer disposes of timber under any form or type of contract whereby he retains an economic interest in such timber, the disposal under the contract shall be considered to be a sale of such timber. The difference between the amounts received for the timber in any taxable year and the adjusted basis for depletion of the timber with respect to which the amounts were so received shall be considered to be a gain or loss upon the sale of such timber for such year. If the taxpayer owned the timber for a period of more than six months prior to the date of such contract, for the purposes of section 117(j) such timber shall

be considered to be property used in the trade or business for the taxable year for which it is considered to have been sold, along with other property of the taxpayer used in the trade or business as defined in section 117(j)(1). Whether gain or loss resulting from the disposition of the timber which is considered to have been sold will be deemed to be gain or loss resulting from the sale of a capital asset held for more than six months will depend upon the application of section 117(j) in the case of the taxpayer.

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